

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Granlund and Papan Analyst: Colin Stevens Bill Number: AB 1159

Related Bills: None Telephone: 845-3036 Introduced Date: 2/25/99

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Depreciation Deduction/Costs of Improvements By Small Business Retail Establishments and Restaurants

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow specified taxpayers who own a store, restaurant or a business with a license to serve alcohol on its premises and who expend \$25,000 or more during the year for building repairs or improvements, to recover the cost of those capitalized repairs or improvements over a three-year period using the straight line method.

This bill also would make changes to the Business and Professions Code relating to smoking in bars, taverns or clubs. This provision will be discussed only as it affects the Franchise Tax Board.

EFFECTIVE DATE

This bill specifies that its tax provisions would apply to taxable or income years beginning on or after January 1, 1999 and before January 1, 2002.

SPECIFIC FINDINGS

Under federal and state laws, the cost of repairing business property is generally deductible as a business expense in the year the cost is paid or incurred. In contrast, an improvement to business property that materially adds to the value or utility of the property or which prolongs its useful life must be capitalized and depreciated over its useful life.

Federal and state laws allow an annual depreciation deduction for exhaustion, wear, and obsolescence of property used in a trade or business or property held for the production of income. **Under the PITL**, California conforms, with modifications, to federal depreciation treatment. **Under the B&CTL**, however, California does not conform to current federal law and, instead, uses the depreciation rules established by prior federal law.

Generally, depreciation for additions or improvements to real property are determined in the same manner as the depreciation deduction for the real property would be determined if the property were placed in service at the same time as the addition or improvement. The applicable depreciation period for additions or improvements to real property generally begins on the later of: the date of the addition or improvement is placed in service, or the date the property is placed in service.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Department Director

Date

Gerald Goldberg

4/16/1999

Under federal law and state laws, lessees are treated as any other taxpayer-owner for purposes of determining depreciation deductions for lessees' improvements, subject to certain rules. Thus, a lessee's depreciation deductions for a leasehold improvement are determined without regard to the lease term. However, at the termination of the lease where the lessee does not retain the improvement, the lessee has a deductible loss equal to the remaining balance of the leasehold improvement.

Existing state law provides for a B&CTL and a PITL alternative minimum tax (AMT). The B&CTL rate is 6.64% for income years beginning on or after January 1, 1997, while the PITL rate is 7% for taxable years beginning on or after January 1, 1996. The AMT was established to ensure that no taxpayers with substantial economic income avoid all tax liability by using exclusions, deductions, and credits (tax preference items).

Under the PITL and B&CTL, this bill would allow an owner of a retail establishment open to the public, a restaurant, or an establishment where the owner possesses a license to sell alcohol on the premises to depreciate the total cost of the expenditure for that repair or improvement over three years using the straight-line method of depreciation. To be eligible for the three-year recovery period, the taxpayer must:

- expend \$25,000 or more during the year for a repair or improvement undertaken pursuant to a building or construction permit issued by a local jurisdiction; and
- own a business that has \$3 million or less in gross receipts, less returns and allowances, during the taxable or income year.

Policy Considerations

This bill would create depreciation differences between federal and California tax law with respect to PITL taxpayers and would create additional differences between federal and California tax law with respect to B&CTL taxpayers thereby increasing the complexity of California tax return preparation.

It appears that this bill is intended to allow accelerated recovery for changes or additions to heating, ventilation and air conditioning systems in order to comply with the provisions of this bill relating to smoking. However, the bill would allow the three-year recovery period for **any** improvement made by a taxpayer who owns a store, restaurant or bar.

This bill does not require that an establishment be located in California in order to receive the accelerated recovery period.

As drafted, this bill would modify the recovery period for depreciating improvements or repairs made by certain taxpayers, but would not modify the accompanying alternative minimum tax (AMT) depreciation provisions. If the AMT provisions are not similarly amended, taxpayers claiming the accelerated recovery period provided by this bill would potentially be subject to significant AMT liability due to the different recovery periods.

Implementation Considerations

The following concerns have been identified. Department staff is available to assist the author to resolve these and other issues that may arise.

A taxpayer would be required to spend \$25,000 or more in a single taxable or income year for one permit or building project in order to qualify for the more favorable depreciation method provided here. If the \$25,000 were spent for a single project over several taxable or income years, a taxpayer would not be eligible for accelerated depreciation under the bill.

The bill defines a qualified taxpayer as "owning" a retail establishment. In the case of an operator of an otherwise qualified facility who makes leasehold improvements required under the Business and Professions Code provisions in this bill, this bill does not specify whether the lessee or lessor is the "owner" and thereby entitled to receive the accelerated recovery period.

It is unclear whether the author intends for taxpayers to be able to claim the accelerated depreciation allowed under this section in addition to other deductions allowed under current law.

This bill is written in a style different from the manner in which modifications to the Internal Revenue Code are generally made in the Revenue and Taxation Code, which could make this bill more difficult for taxpayers to understand and could result in disputes between the department and taxpayers concerning its interpretation.

The bill permits a qualified taxpayer to make an election to depreciate the cost of a repair or improvement over a three-year period, but is silent regarding other aspects of the election, such as when and in what manner the election should be made, whether the election may be revoked, and related concerns.

The bill uses terms and phrases that are not clearly defined, such as "repair or improvement undertaken pursuant to a building or other construction permit issued by a local jurisdiction," "retail establishment open to the public." Uncertainty regarding these terms may generate confusion and disputes between taxpayers and the FTB.

The bill permits a qualified taxpayer to make an election to depreciate the cost of certain repairs and improvements over a three-year period. A qualified taxpayer must own a business that has gross receipts of \$3 million or less, less returns and allowances, during the taxable or income year. It is unclear whether the \$3 million gross receipts limit must be met only in the taxable year during which the expenditure is made and the election is made, or whether the taxpayer must meet the \$3 million qualification for each year of the three-year accelerated depreciation period. If a taxpayer must meet the \$3 million requirement for each year, it is unclear what the effect of failing to meet the \$3 million limit in the years subsequent to the election would be.

Technical Considerations

The reference to a restaurant as defined in Section 27507 of the Health and Safety Code is incorrect as that code section does not exist.

The definition of "qualified taxpayer" under both the PITL and the B&CTL provides that the taxpayer must own a business that has receipts of \$3 million or less, less returns and allowances, during the taxable year. For the B&CTL, the term should be income year.

The bill authorizes an accelerated depreciation period over three years using the straight-line method, but does not clearly identify during which three years the depreciation deduction is to be taken.

FISCAL IMPACT

Departmental Costs

Once the implementation and technical concerns are resolved, this bill is not expected to significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill, under the assumptions discussed below, is estimated to be as follows:

Estimated Revenue Impact					
For Taxable or Income Years					
Beginning on or After 1/1/99					
Assumed Enactment After June 1999					
(In Millions)					
1999-0	2000-1	2001-2	2002-3	2003-4	2004-5
(\$1)	(\$2)	(\$2)	(\$2)	Minor Loss	Minor Gain

Minor = Less than \$500,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

Tax Revenue Discussion

For the purposes of a revenue estimate it is assumed that the changes must be made by a qualified business (i.e., restaurant, bar, or nightclub) to allow patrons to smoke. If the bill is not amended to provide for the above limitations, the revenue loss would be greater.

The revenue impact of this bill would be determined by additional deductions associated with accelerated depreciation by small businesses offset by smaller depreciation deductions in later years as compared to current law.

These estimates were based on departmental data. The following assumptions were applied:

- Taxpayers with positive taxable incomes and not subject to the minimum tax would elect to accelerate depreciation for qualified expenses.
- Based on departmental data, it is estimated that approximately 1,000 small corporations could fully benefit from the increased depreciation deduction. This estimate takes into account the current expensing allowance and the minimum tax interaction.
- It is estimated that the average expenditure would be approximately \$50,000. Of this total it is estimated that approximately one-third would be attributable to mechanical ventilation systems and the balance to other repairs and improvements.
- It is estimated that qualifying PIT taxpayers represent twice that of small corporations.
- It is projected that 20% of qualified taxpayers would make the special depreciation election in 1999, 60% in 2000 and 20% in 2001.
- Estimates were adjusted in out-years to reflect the absence of depreciation deductions that would otherwise apply under current law.

BOARD POSITION

Pending.